

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:CCA:SJ:TL-N-1407-98
LDLawson

date: AUG 18 1999

to: Chief, Examination, Central California District
Attn: Revenue Agent Bill Bosworth

from: District Counsel, Central California District, San Jose

subject: Inclusion of Acquisition in Base Period
Taxpayer: [REDACTED]
EIN: [REDACTED]
Years: [REDACTED], [REDACTED], [REDACTED]

DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

The issue is whether [REDACTED]'s purchase of the [REDACTED] business of [REDACTED] in [REDACTED] constituted a purchase of the major portion of a trade or business of another person, or the major portion of a separate unit of a trade or business of another person, for purposes of I.R.C. § 41(f)(3)(A).

FACTS

Most of these facts have been gleaned from the international examiner's notes, the [REDACTED] Annual Report, and the [REDACTED] memorandum ([REDACTED] memorandum). Please confirm these facts so that we may adjust our position as required.

[REDACTED], headquartered in [REDACTED] California, designs, manufactures and markets advanced [REDACTED] [REDACTED] for a broad range of [REDACTED] [REDACTED] entered into a Stock and Asset Purchase Agreement to acquire the [REDACTED] of [REDACTED]. The agreement, dated [REDACTED], was effective on [REDACTED]. The purchase price was \$ [REDACTED], which was allocated as follows in [REDACTED]'s [REDACTED] annual report:¹

Inventories:	\$ [REDACTED]
Property and Equipment:	[REDACTED]
Intangible Assets:	[REDACTED]
Accrual for Exit Costs:	[REDACTED]
Other assets/liabilities, net	[REDACTED]
Purchased R&D	[REDACTED]
	\$ [REDACTED]

Intangible assets included \$ [REDACTED] of completed technology. \$ [REDACTED] allocated to intangible assets was attributed to workforce in place, supply agreement, and customer lists. To our knowledge, none of the purchase price was allocated to goodwill or going concern per se. Yet we would like to follow up on this advisory and request additional information in this regard. Please provide another copy of the purchase agreement. Also, please provide more information with regard to how the acquisition was treated on the tax return. Indeed, was information furnished by the taxpayer with regard to the acquisition as required for certain asset acquisitions under I.R.C. § 1060(b)?

Per Note [REDACTED] of [REDACTED]'s [REDACTED] annual report, in its [REDACTED] fiscal year, [REDACTED] acquired the [REDACTED] and [REDACTED] Businesses of the [REDACTED] of [REDACTED] in a

¹See [REDACTED] Annual Report, pg. [REDACTED], Note [REDACTED] Acquisition of Businesses from [REDACTED]

transaction accounted for as a purchase. The annual report further provides the following:

Since the fiscal [REDACTED] acquisition of [REDACTED] technology as part of the acquisition of certain businesses of the [REDACTED] of [REDACTED] [REDACTED] has made significant efforts to advance the development of its [REDACTED] capability....

[REDACTED] Annual Report, page [REDACTED]

The acquisition included the following:

- 1) [REDACTED] facilities in [REDACTED], including R&D development and manufacturing operations related to [REDACTED];
- 2) [REDACTED] facilities in [REDACTED], including manufacturing operations for [REDACTED] products and high capacity [REDACTED];
- 3) [REDACTED] manufacturing facilities in [REDACTED];
- 4) [REDACTED] percent of the stock of [REDACTED], an [REDACTED] percent owned subsidiary of [REDACTED] involved in R&D for [REDACTED] technology;
- 5) a renewable, [REDACTED] year supply agreement with [REDACTED] to provide [REDACTED] with [REDACTED] of its [REDACTED] requirements, [REDACTED] of its [REDACTED] requirements, and [REDACTED] of its [REDACTED] requirements.

DISCUSSION

Whether the acquisition constituted a purchase of a major portion of a trade or business or a major portion of a unit of a trade or business, or whether it simply constituted a purchase of certain assets, will affect the components of the base amount for purposes of calculating the R&D credit under I.R.C. § 41.² We do

²See I.R.C. § 41(c).

not, so far, concur with the taxpayer's position that the acquisition was a purchase of certain assets only.

I.R.C. § 41(f)(3) provides the following regarding adjustments for certain acquisitions:

If, after December 31, 1983, a taxpayer acquires the major portion of a trade or business of another person (hereinafter in this paragraph referred to as the "predecessor") or the major portion of a separate unit of a trade or business of a predecessor, then, for purposes of applying this section for any taxable year ending after such acquisition, the amount of qualified research expenses paid or incurred by the taxpayer during periods before such acquisition shall be increased by so much of such expenses paid or incurred by the predecessor with respect to the acquired trade or business as is attributable to the portion of such trade or business or separate unit acquired by the taxpayer, and the gross receipts of the taxpayer for such periods shall be increased by so much of the gross receipts of such predecessor with respect to the acquired trade or business as is attributable to such portion.

I.R.C. § 41(f)(3)(A). Treas. Reg. § 1.41-9(b), regarding adjustments for certain acquisitions and dispositions, refers us to Treas. Reg. § 1.52-2(b) for the respective meanings of "acquisition," "separate unit," and "major portion."

An acquisition of physical assets alone will not constitute an acquisition of the major portion of a trade or business or the major portion of a separate unit of a trade or business. An acquisition must transfer a viable trade or business. Treas. Reg. § 1.52-2(b)(1)(ii). A separate unit of a trade or business is a segment of a trade or business which is capable of operating as a self-sustaining enterprise with minor adjustments. Treas. Reg. § 1.52-2(b)(2). Allocation of a portion of the goodwill of a trade or business to a segment is strong indication that the segment is a separate unit. *Id.*

Whether the transfer includes a major portion of a trade or business or separate unit thereof, will depend upon a facts and circumstances analysis. The following factors must be considered:

- 1) the fair market value of the assets of the portion transferred relative to the fair market value of the

other assets of the trade or business (or separate unit);

- 2) the proportion of goodwill allocable to the portion of the trade or business (or separate unit);
- 3) the proportion of the number of employees of the trade or business (or separate unit);
- 4) the proportion, allocable to the portion, of the sales or gross receipts, net income, and budget of the trade or business (or separate unit).

Treas. Reg. 1.52-2(b)(3).

We recommend you factually develop this issue if you have not already done so. Note, however, that the [REDACTED] memorandum is unconvincing. In the conclusion, [REDACTED] bases its final opinion, that there was no a transfer of a major portion of a trade or business (or separate unit), upon four unsupported conclusions.

[REDACTED] asserts that no goodwill was acquired in the transaction, but this is clearly wrong. Although the regulations do not provide that goodwill must be included per se (nor do they define goodwill for these purposes), we need not debate that. The taxpayer's allocation does not preclude a finding that there was an acquisition of goodwill here. Goodwill and going concern value were in fact included in the [REDACTED] acquisition. (Goodwill includes the expectation of continued patronage. See *Metallics Recycling Co. v. Corporation*, 79 T.C. 730 (1982);³ *VGS Corporation v. Commissioner*, 68 T.C. 563 (1977). The client lists and supply agreements provide for continued patronage. Indeed client lists have been placed under the purview of goodwill. Further, going concern value was acquired in the purchase of a workforce in place and other intangibles. (Going concern is also deemed to fall within the umbrella of goodwill.)

The [REDACTED] memorandum concludes that the assets purchased did not constitute a viable business. This assertion is unsupported. We simply need more information on this issue, however, it is conceivable that four of the five items that we listed in the

³The [REDACTED] memorandum cites to *Metallics Recycling Co.* and attempts to distinguish it from the instant matter, but provides no basis for the distinction.

purchase could constitute major portions of a trade or business (or separate unit). Or, it is possible that the items together do this.

For instance, most of the assets and workforce in place of the [REDACTED] were acquired. Goodwill was acquired. We do not have sufficient information to determine whether any of these units were self-sustaining at the time of the acquisition. However, these are the types of assets that enable a business to remain self-sustaining. The claim that portions of the infrastructure were not included in the transaction, if that is indeed the case, again does not tell the whole story. The assertions made need to be tested for accuracy and probed for applicability. We recommend obtaining information addressing whether any (or all) of the assets acquired were viable. Let's discuss what information may lead to an analysis on this point in accordance with the examples at Treas. Reg. § 1.52-2(b)(2)(ii).

[REDACTED] asserts, again without support, that no key employees were included in the transfer. First, this is not a conclusive factor. Further, there is no support for this position. The key employees for these purposes have not been identified. [REDACTED]'s claim that significant changes were made to the operations of the acquired assets is equally unsupported. In addition, whether changes have been made, may not be decisive. The regulations simply provide that the separate unit be capable of operating as a self-sustaining operation with minor adjustments. We should delve further in this area. We need to find out if the operations purchased fit this definition.

The Technical Advice Memoranda relied upon by [REDACTED] are unpersuasive on this point. Finally, there is the major portion element under Treas. Reg. § 1.52-2(b)(3). The [REDACTED] discussion does not apply the elements set forth in the regulations (presumably because the author has already concluded that neither a trade or business or a separate unit thereof was involved). We do not believe this element should be ignored, as we cannot conclude that a trade or business or separate unit of a trade or business was not a subject of the transaction. On this point, we recommend that you ask the taxpayer for the relative allocations, or information regarding said allocations, as set forth at Treas. Reg. § 1.52-2(b)(3). If the taxpayer does not have this information, along with information on other factors, how can the taxpayer assert that there was substantial authority for failing to make an adjustment for the acquisition as required under the provisions of I.R.C. § 41(f)(3)(A)?

CONCLUSION

In accordance with the above discussion, we need additional information from you to affirmatively state whether the [REDACTED] acquisition constituted or included the acquisition of a major portion of a trade or business (or separate unit). Also, in accordance with the above discussion, we do not recommend that you deem the [REDACTED] memorandum to be conclusive on this issue. The analysis therein is at points flawed and, currently, without support.

Thank you for your attention to this matter. If you have any questions regarding this memorandum, please telephone LaVonne Lawson at (408)817-4668.

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District Counsel

By:



LaVONNE D. LAWSON
Attorney